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July 18, 2001

Re: Change in Ownership - Irrevocable Trust

Dear Mr. _____ :

This is in response to your June 6, 2001, letter to Ms. Kristine Cazadd wherein you requested our opinion as to whether a proposed termination of an irrevocable trust and distribution of the trust's real properties to the current income beneficiaries in equal shares could be excluded from change in ownership and from reassessment. For the reasons hereinafter set forth, it is our opinion that the termination of the trust and distribution of the trust's real properties to the current income beneficiaries in equal shares would not constitute changes in ownership under these circumstances, pursuant to Property Tax Rule 462, subdivision (d)(1) and subdivision (d)(6). However, since we have not received a copy of the trust instrument, our analysis is limited to the specific trust provisions which you have provided in your letter.

Facts

According to your letter, the facts are as follows:

On December 31, 1980, a husband and wife, as trustors, and an independent third party, as trustee, created an irrevocable trust (the "1980 Irrevocable Trust"). The trust has subsequently purchased several parcels of real property located in the state of California ("Trust Properties"). The trustors have not contributed any real property to the trust.

Certain trust provisions are:

Section 2.01: "the Trustee at the end of each taxable year of this trust shall pay to or apply for the benefit of Trustor's children, [Child A, Child B, Child C, and Child D], herein called "Income Beneficiaries", in such proportions as the Trustee in his absolute discretion may from time to time determine, all of the net income of the Trust Estate."

Section 2.02: "[o]n the death of any of the Income Beneficiaries, the interest in this Trust of such deceased beneficiary shall terminate and thereafter the Trustee shall at the end of each taxable year of this Trust pay to or apply for the benefit of the surviving Income Beneficiaries, in such proportions as the Trustee in his absolute discretion may from time to time determine, all of the net income of the Trust Estate."

Section 2.03: "[t]he Trustee may at any time and from time to time, in addition to the net income of the Trust Estate, pay to or apply for the benefit of any of the Income Beneficiaries such amounts as the Trustee may elect from the principal of the Trust Estate, up to the whole thereof, if the Trustee determines, in his absolute discretion that it is in the best interests of the Income Beneficiaries to do so."

Section 2.04: "[u]pon the death of the last Income Beneficiary to die, the Trust shall be divided into separate shares so as to provide one (1) share to each group composed of the living issue of a deceased child of the Trustor and shall be distributed or retained in trust as" further provided in the trust.

Child A died without issue on January 3, 1995. Income distribution deductions were taken in 1987 and 1990-1995.

Proposed Termination

The Trustee proposes to terminate the trust by distributing the Trust Properties in equal shares to Child B, Child C, and Child D.

Your Analysis

Under Property Tax Rule 462.160, subdivision (d), the termination of the trust and the distribution of the Trust Properties to the remaining income beneficiaries would not be a change in ownership. The termination of the trust results in the distribution of the Trust Properties to the beneficiaries who have a present interest in the trust.

Applying the rule, *Allen v. Sutter County Board of Equalization* (1983) 139 Cal. App. 3d 887, and SBE precedent opinions to the terms of the trust, Child B, Child C, and Child D have present interests in the trust. The death of Child A did not give rise to any present beneficial interest by any grandchild and does not result in the transfer of a present beneficial interest to any other remaining income beneficiaries because they (Child B, Child C, and Child D) each already have a beneficial interest in the Trust Properties because of the sprinkling provision. The grandchildren's interests are future interests and will only become present interests upon the death of the last surviving child.

Analysis

Changes in Ownership - Irrevocable Trust's Acquisitions of Real Properties

Section 60 defines a change in ownership as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest."

Section 61 then provides that "except as otherwise provided in section 62, change in ownership as defined in section 60, includes, but is not limited to: (h) Any interests in real property that vest in persons other than the trustor (or, pursuant to Section 63, his or her spouse) when a revocable trust becomes irrevocable. This subdivision reflects the conclusion reached by the Legislature in implementing Proposition 13, as set forth in Assembly Revenue and Taxation Committee, *Property Tax Assessment*, Volume I, October 29, 1979, requiring a change in ownership whenever there is a transfer of the beneficial use of the property.¹ As stated in Property Tax Rule 462.160, Change in Ownership - Trusts, subdivision (a), Creation, the general rule is that the transfer by the trustor, or any other person, of real property into a trust is a change in ownership of such property at the time of the transfer.

Consistent therewith, husband and wife's transfer of real property into the irrevocable trust, had there been any, would have been changes in ownership pursuant to section 60, absent any available exclusion or exception, such as the parent-child exclusion of section 63.1.

As indicated, the trust subsequently purchased several parcels of real property located in California. Pursuant to Rule 462.160, subdivision (a), the transfer of the real properties to the trust were changes in ownership pursuant to section 60, absent any available exclusion or exception. We assume that the County Assessor regarded these transfers of real property to the trust as changes in ownership and reassessed the properties.

Irrevocable Trust - Trustee's Discretion to Make Distributions of Income or of Income and Principal.

An additional consideration in instances involving irrevocable trusts is the presence or absence of a "sprinkle power" and, in cases of irrevocable trusts that contain sprinkle powers, what those provisions are and to which beneficiaries they pertain. Thus, a trust instrument must be reviewed for the presence of a "sprinkle" power.

¹ On page 19 of Volume I, this requirement is explained as follows:

"Beneficial use is necessary to protect custodianships, guardianships, trusteeships, security interests, and other fiduciary relationships from unintended change in ownership treatment. For example, a father buys land for his minor son, taking title as custodian for the son. There IS a change in ownership when the father buys the property; however, when the son reaches majority and gets the property outright there is no change in ownership. This is because the father never had the beneficial use of the property. The son was the real owner from the outset and when he reached majority there was no transfer of the beneficial use."

A "sprinkle or spray power" is a provision which gives the trustee total discretion to distribute trust income or property to a number of potential beneficiaries. When a trust contains a sprinkle or spray provision, to avoid change in ownership and reassessment, all of the persons included as beneficiaries under that provision must have an exclusion.² If even one person included as a beneficiary is not excludable, then 100 percent of the trust property is subject to change in ownership.

The principle is expressly described in Rule 462.160(b)(1)(A) as follows:

"... Where a trustee of an irrevocable trust has total discretion ('sprinkle power') to distribute trust *income or property* to a number of potential beneficiaries, the property is subject to change in ownership, because the trustee could potentially distribute it to a non-excludable beneficiary, unless all of the potential beneficiaries have an available exclusion from change in ownership."

Thus, where a trustee of an irrevocable trust has "sprinkle power" to distribute trust income or income and principal only to trust beneficiaries holding present interests in the trust, the trust property would not be subject to change in ownership because of the "sprinkle power", since the trustee could not distribute any income or principal to a non-excludable beneficiary.

On the other hand, if the trust provided that any beneficiary, present or future, could receive trust income or income and principal, a change in ownership of all of the trust property would occur. Anyone who at the current time can receive a "present interest" in some, or all of the income in an irrevocable trust becomes the sole present beneficiary under the sprinkle power; therefore, everyone in that group must have an available exclusion. This is clarified by Example 2 in Rule 462.160(b)(1)(A):

"Example 2: H and W transfer real property interest to the HW Revocable Trust. No change in ownership. HW Trust provides that upon the death of the first spouse the assets of the deceased spouse shall be distributed to A Trust, and the assets of the surviving spouse shall be distributed to B Trust, of which surviving spouse is the sole present beneficiary. H dies and under the terms of A Trust, W has a sprinkle power for the benefit of herself, her two children and her nephew. When H dies, A Trust becomes irrevocable. There is a change in

² There are three possible categories of "excludable beneficiaries." These are trustor-transferors and spouses (spouse of the trustor-transferor, eligible under section 63), children of the trustor-transferor (eligible under section 63.1 and claiming the parent/child exclusion), and grandchildren of the trustor-transferor (claiming under section 63.1, provided that the parents of those grandchildren are deceased). Example 1 under Rule 462.160 (b)(1)(A) illustrates how an exclusion applies and then terminates:

"Example 1: M transfers income-producing real property to revocable living Trust A, in which M is the sole present beneficiary. Trust A provides that upon M's death, Trust A becomes irrevocable, M's brother becomes a present beneficiary, and income from the trust property is to be distributed to B for his lifetime. Upon M's death, 100% of the property in Trust A, representing B's present beneficial interest, undergoes a change in ownership."

ownership with respect to the interests transferred to the A Trust because the sprinkle power may be exercised so as to omit the spouse and children as present beneficiaries for whom exclusions from change in ownership may apply, and there are no exclusions applicable to the nephew. However, if the sprinkle power could be exercised only for the benefit of W and her children for whom exclusions are available, the interspousal exclusion and the parent/child exclusion would exclude the interests transferred from change in ownership, provided that all qualifying requirements for those exclusions are met."

Based upon the description of the trust in this matter, the Trustee's sole discretion to distribute income or income and principal to Child B, to Child C, and/or to Child D only and not to any other (future) beneficiaries constitutes a "sprinkle power" to only trust beneficiaries holding present interests in the Trust Properties and hence, imposes no change in ownership consequences upon Trust Properties, either during the existence of the trust or, as hereinafter explained, upon the proposed termination of the trust. Since Child A died without issue, his interest in the trust and Trust Properties as an income beneficiary terminated in 1995 (section 2.02), and was paid or applied to the benefit of his siblings. The provision in section 2.04 allowing a share to each child's living issue is not applicable to Child A.

Changes in Ownership - Proposed Trust Transfers of Trust Real Properties to Trust Beneficiaries having Present Interests in the Trust and Trust Properties.

The termination of an irrevocable trust and transfers of real property to the trust beneficiaries may not constitute changes in ownership for purposes of Article XIII A of the Constitution. Again, pursuant to Property Tax Rule 462.160, the general rule is that the termination of a trust constitutes a change in ownership at the time of the termination of the trust (subdivision (c)). However, subdivision (d) sets forth several exceptions to the general rule, one of which is that subdivision (d)(1):

(d) Exceptions. The following transfers do not constitute changes in ownership:

(1) Prior Change in Ownership. Termination results in the distribution of trust property according to the terms of the trust to a person or entity who received a present interest (either use of or income from the property) when the trust was created, when it became irrevocable, or at some other time...

Another exception to the general rule is that of subdivision (d)(6)

6. Proportional Interests. Termination results in the transfer to the beneficiaries who receive the same proportional interests in the property as they held before the termination of the trust.

As you know, these results follow from the statutes and from the case of Allen v. Sutter County Board of Equalization, *supra*, to which you refer in your letter:

Allen v. Sutter County Board of Equalization, (1983) 139 CA 3d 887.

In 1961, a husband and wife conveyed property in trust for the benefit of their four grandchildren. The trust provided that the property was to be divided into four equal parts, and the trustee had discretion to distribute income until age 21 and thereafter the trustee was required to distribute income. At the time the youngest beneficiary reached age 25, the trustee was directed to distribute to each beneficiary his or her share of the trust. If a beneficiary died before reaching age 25, the trustee was to distribute that beneficiary's share to his or her issue, or if none, the property was to be added to the other shares.

On June 13, 1978, the youngest grandchild reached age 25 and the trustee conveyed the property in equal shares to the four grandchildren. The assessor reassessed on the theory that the termination was a change in ownership.

The court of appeal held that the termination of the trust was not a "change of ownership". The court stated that the creation of the trust was a change of ownership and that at the time of the creation of the trust the grandchildren had an equitable interest in the property:

"A change of ownership means the transfer of a present interest in real property including the beneficial use thereof." *139 Cal. App. 3d 887, 890*. "In the case of a trust, as here involved, not all of the criteria required to constitute a change of ownership are present. There was no transfer of the beneficial use of the property when the trust was terminated." *Id.*

Finally, the court cited former Property Tax Rule 462(i)(4) which provided that a termination of a trust was not a change of ownership if the termination resulted in the transfer to beneficiaries who received the same proportional interests in the property as they held before the termination of the trust. *139 Cal. App. 3d 887, 892*.

In this instance, the proposed termination of the trust would result in the transfer of the Trust Properties to Child B, Child C, and Child D, who received present interests in the trust and

any Trust Properties at the time the irrevocable trust was created, and, thereafter, who upon Child A's death became the sole owners of present interests in Trust Properties, including the real properties, subsequently added to the trust. Thus, pursuant to Rule 462.160, subdivision (d)(1)³ and *Allen v. Sutter County Board of Equalization, supra*, the proposed termination of the trust and transfers of the Trust Properties to the remaining children, Child B, Child C, and Child D, having present interests in the trust and Trust Properties would not constitute changes in ownership. Similarly, since the proposed termination of the trust would result in the transfer of the Trust Properties to the present beneficiaries in the same proportional interests in the properties as they held before the termination, Rule 462.160, subdivision (d)(6) also would preclude the transfers of the Trust Properties to the children from constituting changes in ownership.

The views expressed in this letter are advisory only. They represent the analysis of the legal staff of the Board based on the present law and facts set forth herein and are not binding on any person or entity. You may wish to contact the County Assessor's office to ascertain whether it is in agreement with the analysis and conclusions set forth herein.

Very truly yours,

/s/ James K. McManigal, Jr.

James K. McManigal, Jr.
Tax Counsel IV

JKM:lg

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Cc:

Mr. Richard Johnson, MIC:63
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³ Rule 462.160, subdivision (d)(1) does continue on to state that a change in ownership does occur when the remainder or reversionary interest becomes possessory if the holder of that interest is a person or entity other than the present beneficiary, unless otherwise excluded from change in ownership. Such would not be the case in this instance, however, since under the proposed transfers, only Child B, Child C, and Child D, original trust beneficiaries with the present interests in the trust and Trust Properties would be the only transferees of the Trust Properties. Also, the earlier death of Child A would not compel a different result because Child A died without issue, thereby ending his present interest and leaving no remainder or reversionary interest to address.